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NOLs can bring businesses tax refunds

by Jennifer Shafer

Tax time can be painful, especially if cash is tight. But for businesses that suffered a net operating loss (NOL), there is, perversely, a bit of light at that time of year. NOLs can be used to offset income from other tax years and bring in cash in the form of refunds.

A NOL occurs when "income is less than deductions or expenses," stated Michelle Klement, tax shareholder with the Maumee-based William Vaughan Company.

When it happens, the business or individual is allowed to carry the amount of the loss back a certain period (normally two years) and apply it to that year's tax return, reducing that year's income. If any of the loss is left over, that amount can be carried forward to the next year and up to 20 years after the year in which it was incurred. For example, a NOL in 2008 could be applied to income from 2006, then 2007, and so on for any year in the next 20 that earns income if part of the loss is left over.

"If you run a deficit in a year, it doesn't mean you just dug yourself a hole and that's what you're left with," Klement added. "You can use that ditch and move it forward or move it back and net with those years when you actually have some income. So it's not lost forever."

If the previous two years had no or little income, the NOL can be carried forward and the carry back option waived. Either way, the NOL must be applied to each subsequent year, starting with the earliest. Under special circumstances, the carry back

period is increased; for casualty losses or theft, it's three years and for farming losses it's five.

There have also been periods in history when the general carry back period has been increased. For example, in 2001 and 2002, the carry back period became five years due to the economic slump caused by the September 11 attacks. Klement has seen no indication that such an exception would be made for 2008, though it's a possibility for 2009.

A NOL will often be part of an individual's tax return rather than a business'. Such individuals are generally shareholders in an S corporation, a partnership, or an LLC, which are "pass-through entities" that don't pay taxes.

Individuals who believe they can take advantage of a business NOL need to make sure they're following the rules, Klement warned. "If you have a loss from a business that's a pass-through business, you have to have enough basis in your ownership" to claim the loss, she stated.

"Basis is created by putting money in. 'I want to become a shareholder, I want to start this S-corp, so I'm going to put a thousand dollars into it in order to get stock and be an owner.' So I've got a thousand dollars worth of basis because I've had an economic outlay," she explained. "There has to be some true economic outlay or financial risk on the line, by you, in order for you to claim those deductions."

Her advice? Track your basis and your at-risk status, meaning you've had a true financial outlay related to the business. A NOL is only claimable for someone who has both. At-risk status depends on circumstances and on the type of business; an LLC is designed such that shareholders aren't liable for debt, so they may not be able to use a NOL.

"Having tracked your basis and your at-risk is vital," Klement noted. "You can find yourself trying to do something you're really not entitled to, without even knowing it. And then it may come to haunt you later down the road if the IRS were to challenge it."

Another potential pitfall Klement noted was that a NOL can be different for regular tax purposes and for Alternative Minimum Tax (AMT). A NOL could be \$100,000 for regular federal tax purposes

and \$95,000 or \$120,000 under AMT. Depreciation and investments, among other issues, can be different amounts under the two systems.

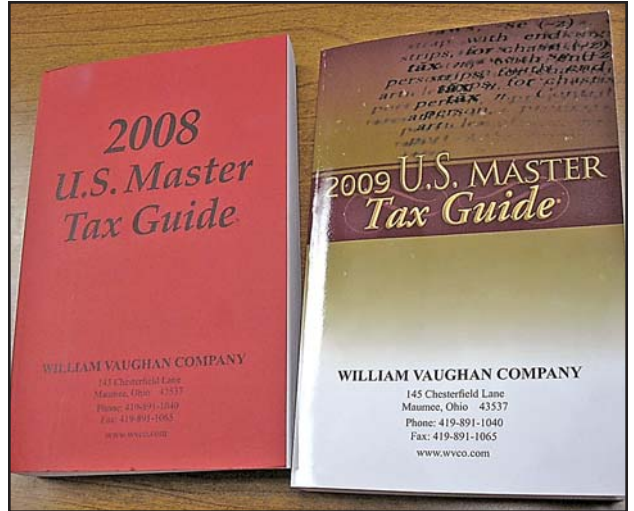
Individuals have three years from the date the NOL is incurred to amend other years' tax returns while corporations have one year. Klement's practice generally completes the appropriate form – 1045 for individuals and 1139 for corporations – at the same time as the tax return for the year in which the NOL is incurred. Once a year's federal return is amended, it's important to file amended state tax returns as well, she explained.

How much can a NOL help? It's never as good as a positive-cash-flow year, according to Klement, but it can return sizable amounts of tax already paid. A big enough NOL can reduce a previous year's tax bracket and amount of tax owed significantly.

"If we're talking \$100,000 for a corporation, they're paying about 35%; whereas if we're talking \$50,000, they're paying 15%," Klement stated.

In certain circumstances, it might be desirable to create a NOL through investments, charity contributions, and so on; but only in a year that wouldn't have been very profitable anyway, Klement explained, and particularly if the previous years were significantly high-income years.

Klement's overall advice is for businesses to keep tight control of their finances in order to minimize their taxes. "Right now our focus is really more advice on cash restriction; people are seeing more and more inability to make their expenses," she stated. "So rather than advising on incurring or creating NOLs, we're trying to do the opposite, trying to structure things, and looking at things ahead of time enough in order to tighten up spending or do things to accelerate cash inflow."



Michelle Klement, tax shareholder,
William Vaughan Company